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ORIGINAL

DOCKET # 98-77 ORIGINAL

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SEP 17 1998

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

September 17, 1998

Ms. Magalie R. Salas  
Secretary  
Federal Communications Commission  
Room 222  
1919 M Street, N.W.  
Washington, D.C. 20554

**Re: In the Matter of Access Charge Reform for Incumbent Local  
Exchange Carriers Subject to Rate-of-Return Regulation; CC Docket  
No. 98-77**

Dear Ms. Salas:

Enclosed herewith for filing are the original and sixteen (16) copies of MCI WorldCom Reply Comments regarding the above-captioned matter.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI WorldCom Reply Comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Don Sussman

Enclosure  
DHS

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Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, DC 20554

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SEP 17 1998

FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF THE SECRETARY

In the Matter of

Access Charge Reform for Incumbent  
Local Exchange Carriers Subject to  
Rate-of-Return Regulation

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CC Docket No. 98-77

MCI WORLDCOM REPLY COMMENTS

I. Introduction

MCI WorldCom, Inc. (MCI WorldCom) hereby submits these reply comments regarding the Notice of Proposed Rulemaking (Notice) in the above-captioned proceeding, released June 4, 1998.<sup>1</sup> In that Notice, the Commission proposes to reform the access rate structure of rate-of-return incumbent local exchange carriers (ILECs) to better reflect the manner in which costs are incurred (e.g., recovering non-traffic sensitive costs through flat rate charges and traffic sensitive costs through per minute charges wherever possible). The Commission-proposed rate structure for rate-of-return ILECs is similar to the structure ordered by the Commission for the price cap ILECs in its May 7, 1997 First Report and Order.<sup>2</sup>

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<sup>1</sup> In the Matter of Access Charge Reform for Incumbent Local Exchange Carriers Subject to Rate-of-Return Regulation, CC Docket No. 98-77, FCC 98-101, Notice of Proposed Rulemaking (Notice), released June 4, 1998.

<sup>2</sup> Access Charge Reform, CC Docket No. 96-262, First Report and Order, (First Report and Order) 12 FCC Rcd 15982 (1997) (Access Charge Reform Order); Order on

**II. There Is Industrywide Consensus That the Commission Should Revisit Access Reform for Price Cap Carriers and Complete Universal Service Reform Before Diverting Its Limited Resources to Access Reform of Rate-of-Return Carriers**

In Comments filed August 17, 1998, MCI supported the Commission's fundamental finding that access rates should, wherever possible, reflect the manner in which costs are incurred,<sup>3</sup> and its conclusion that access reform for all ILECs, including rate-of-return ILECs, is critical to achieving Congress' ultimate goal of a fully competitive local telecommunications marketplace.<sup>4</sup> MCI pointed out, however, that the time is not now ripe for the Commission to divert its limited resources to reform the access rate structure of rate-of-return ILECs. Rather, the Commission should first resolve issues that could lead to reform of pricing of over 90 percent of access lines (i.e., continued price cap ILEC access and universal service reform), creating significant benefits for all Americans, before embarking on a rulemaking that could require over a thousand small independent ILECs to provide annual cost studies, that could require small carriers to increase investment to ensure that reform policies are implemented as ordered, and that would ultimately impact less than ten percent of interstate access lines.

The overwhelming majority of parties filing comments in this proceeding concur that the Commission should delay its reform of rate-of-return ILECs' access structures

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Reconsideration, 12 FCC Rcd 10119(1997); appeal pending sub nom. Southwestern Bell Tel. Co. v FCC, No. 97-2618 (and consolidated cases)(8th Cir. argued Jan. 15, 1998); Second Order on Reconsideration; 12 FCC Rcd 16606 (1997).

<sup>3</sup> MCI Petition at 2.

<sup>4</sup> Id.

until the Commission has completed its reform of price cap ILECs' access structures<sup>5</sup> and of universal service.<sup>6</sup> Continued access reform of price cap ILECs' access rates is necessary to ensure the development of widespread competition in all telecommunications markets, and universal service reform is necessary to determine the amount of universal service support required to ensure the availability of basic, affordable telephone service throughout America, and clarify the manner in which carriers are allowed to recover their universal service obligations from customers. Until the Commission resolves the issues regarding the level of universal service support for the rural companies, incentives for entry into the market for local service in these areas will be distorted, because support will not be based on the economic cost of providing service. These distorted incentives will of necessity also affect entry into the market for access services. Thus, it is critical that the Commission resolve both the universal service and access reform issues at the same time.

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<sup>5</sup> Price cap ILECs' access charges continue to exceed economic cost by approximately \$10 billion.

<sup>6</sup> Among issues, for price cap ILECs the Commission still must (1) select a model platform; (2) determine the inputs to be used in that platform; (3) determine the revenue benchmark to be used to set the support level, and; (4) determine how carriers will be assessed for their portion of universal service support. Then, the Commission must go through these same steps to determine the universal service support level for rural carriers.

**III. The Commission Should Increase Rate-of-Return Carriers' Multiline Business and Non-primary Line SLC Caps to at Least the Same Level Currently in Effect for Price Cap ILECs.**

Should the Commission decide to proceed with rate-of-return carrier access reform, MCI WorldCom supports, in principle, the Commission's proposals to apply to rate-of-return carriers many of the rate structure changes that it applied to price cap carriers in the First Report and Order. In comments filed to date, no rate-of-return carriers have factually demonstrated that they incur costs in a manner that is not similar to price cap carriers. Consequently, the Commission should establish a long-term goal of aligning the rate-of-return ILECs' rate structure with the price cap ILECs' rate structure.

Several of the rate-of-return ILECs argue in their comments that, if the Commission adopts its proposed rate-structure modifications, then the multiline business Subscriber Line Charge (SLC) which rate-of-return ILECs are permitted to charge should be set no higher than the national average rate charged by the price cap ILECs (rather than adopting the same "caps"), and that costs that they cannot recover through the SLC should be recovered through existing per minute charges (Carrier Common Line Charges and the Transport Interconnection Charge), and then through universal service mechanisms. They contend that under a scenario where a rate-of return carrier's SLC is equal to the price cap carriers' cap, the rate-of -return ILEC's rates for SLC would likely be higher than the price cap carrier's charged rates because rate-of return carriers have higher costs to recover (due to less densely populated areas, longer loops, and less friendly terrain). They claim this would expose them to "cream skimming."

The Commission should not adopt the suggestion in the Notice that rate-of-return carriers' multiline business SLC be capped at the level of the neighboring price cap LEC's SLC or at the national average of price cap LECs' SLCs.<sup>7</sup> If a rate-of-return carrier's SLC were capped at the level of the neighboring price cap LEC's SLC, a greater proportion of the rate-of-return carrier's common line costs would have to be collected from IXCs through per-minute rates. As the Commission found in the First Report and Order, a SLC cap below \$9.00, and the resulting recovery of NTS costs through per-minute rates, creates an impermissible cross-subsidy from high-volume to low-volume long distance customers.<sup>8</sup>

Further, the concern expressed by many of the rate-of-return ILECs that the higher SLC cap will provide an incentive for price cap carriers or competitive carriers to "cherry pick" rate-of-return carriers' multiline business customers is misplaced. Under the Commission's theory of the market-based approach to access reform, it is the existing rate structure that creates incentives for competitors to target an ILEC's most profitable customers.<sup>9</sup> Throughout the First Report and Order, the Commission emphasizes that, by decreasing the revenues recovered through per-minute charges, the increase in the multiline business SLC cap reduces opportunities for new entrants to target high-volume customers.<sup>10</sup>

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<sup>7</sup>Notice at ¶40.

<sup>8</sup>First Report and Order at ¶82.

<sup>9</sup>Id. at ¶76.

<sup>10</sup>Id.

#### **IV. Rate of Return ILECs Have Not Demonstrated That They Require Additional Pricing Flexibility At This Time**

Many of the rate-of-return carriers and their associations request that the Commission increase the pricing flexibility afforded to the rate-of-return ILECs either prior to, or at the same time the Commission reforms current access structures. They claim that the competitive threat they face is real, and that the Commission proposal to make access charges more reflective of cost causation principles would increase their risk of losing their few profitable customers. Lexicom Telephone Company goes so far as to request overall rate deregulation of the smaller ILECs due to the "market vulnerability for rural ILECs."<sup>11</sup>

On May 7, 1998, MCI filed with the Commission a report confirming that exchange access markets remain the dominion of the incumbents, and that the very limited presence of facilities-based competitors has failed to produce downward price pressure that the Commission anticipated when it adopted its Access Reform decision for price cap carriers. New entrants have been limited to facilities construction as a mode of entry. Because facilities-based network construction is slow and capital intensive, competitive local exchange carrier (CLEC) networks reach only a fraction of the buildings served by ILEC networks. With such limited network reach, CLECs receive less than 1 percent of the nation's switched access revenues.

The report also shows that one year after the adoption of the Access Reform Order, and almost two years after the adoption of the Local Competition Order, CLECs

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<sup>11</sup> Lexicom Petition at iv.

offering commercial service have been limited to using their own facilities or, to a limited degree, their own facilities in combination with ILEC loops. Unbundled loops as a service delivery method account for less than 0.1 percent of Regional Bell Operating Company (RBOC) and GTE access lines: of a total of 144.5 million access lines, only 123,680 have been sold to CLECs as unbundled elements. As a measure of how insignificant this figure is, the RBOCs and GTE are expected to add 6 million access lines between 1997 and 1998. ILECs have no incentive to respond to such minimal levels of competitive entry.<sup>12</sup>

Considering the presence of new entrants in the largest local markets (served by price cap ILECs), no merit can be given to the rural carriers' contention that they now require immediate pricing flexibility to ward off entry of new competitors. Recently, J.P. Morgan Securities Inc issued a Company Report on Century Telephone Enterprises (Century), which it refers to as "the premier consolidator of rural properties."<sup>13</sup> Century is the 10th largest local wireline and wireless operator in the country.<sup>14</sup> J.P. Morgan states that:

Century's rural profile offers a number of attractions for investors because its rural profile has been enjoying a resurgence in population growth....[and] Century's rural markets are less attractive to potential competitors (wireline and

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<sup>12</sup> Even MCI Worldcom, which had spent more than \$2 billion entering local markets, is currently operating in approximately 100 cities, and which long ago adopted a corporate policy of diversifying access vendors, has been stymied in its attempts to find and exercise competitive choice for its own exchange access arrangements.

<sup>13</sup> See Attached Report. J.P. Morgan Report at 1.

<sup>14</sup> Id.



wireless) than major metro markets, a position that is reinforced by special protection under the Telecommunication Act of 1996.<sup>15</sup>

The report also notes that by virtue of being small and rural, rate-of-return ILECs, such as Century, are exempt from Section 251 and 252 of the Telecommunications Act ( which relate to interconnection requirements and procedures for negotiation, arbitration, and approval of agreements,) and are not obligated to resell its services at a discount, provide number portability, or interconnection. The Wall Street report also takes note that these smaller carriers are also already allowed to provide long distance services.

Merrill Lynch also notes that Century, itself, has:

stressed the benefits of being a rural telecommunications provider. Costs, taxes and wages have remained low while rural America has experienced a resurgence in population growth. Furthermore, competitors have been reluctant to enter rural areas.<sup>16</sup>

Paine Webber noted that "...rural operations offer higher growth and less competition than is seen in major markets."<sup>17</sup>

Similarly, in August, Furman Selz reported that ALLTEL, which has 1.8 million local telephone lines, and which serves smaller metropolitan and rural markets is "likely to experience less competition than more urban markets."<sup>18</sup> It also commented that

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<sup>15</sup> Id. at 2.

<sup>16</sup> See attached "Fixed Income Research: Highlights from Century's Analyst Meeting," September 16, 1998, J. Borthwick, Merrill Lynch.

<sup>17</sup> See attached "Century Telephone: Notes from Investor Meeting," Walter Piecyk/William Choi, Paine Webber, September 16, 1998.

<sup>18</sup> Id.

ALLTEL's "complete suite, or 'bundle' of services, which not only maximizes the revenue and profit potential per customer, ...creates high customer loyalty."<sup>19</sup>

"In general, absent a major technology advancement, rural telecommunications companies should face little competition"

In June, Morgan Stanley Dean Witter stated that "[r]ural markets face less competition," and that:

RLECs (rural LECs) have been accused by some of goldplating their networks. In reality, these advanced networks inevitably can also become an economic barrier to entry for potential competitors.<sup>20</sup>

It is evident that the access reform policies adopted by the Commission on May 7, 1997 for price cap carriers has been a nonevent, and that more than one year later, widespread competition has not yet emerged in the largest metropolitan areas. It is equally evident that the smaller rural rate-of-return carriers continue to benefit from the Telecommunications Act (e.g., exemption from 251 and 252 interconnection requirements), without facing competitive circumstances that would warrant additional pricing flexibility at this time. Their request for added pricing flexibility should be dismissed.

## **V. Conclusion**

Wherefore, MCI WorldCom urges the Commission to re-visit and significantly modify its access reform policies for price cap ILECs and to complete its reform of

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<sup>19</sup> Id.

<sup>20</sup> "Century Telephone Enterprises (CTL): The Rural Rebound Uncovers a Telecom Sweet Spot!." Steve Franck, Morgan Stanley Dean Witter, June 26, 1998

universal service before it embarks on reforming the access rate structure of rate-of-return carriers. Should the Commission decide to proceed with rate-of-return carrier access reform, the Commission should limit the immediate rate structure changes for rate-of-return carriers to (1) increasing the SLC ceiling; and (2) replacing the per-minute CCL with the per-line PICC.

Respectfully submitted,  
MCI WORLDCOM, INC.

Don Sussman  
1801 Pennsylvania Ave., NW  
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(202) 887-2779

September 17, 1998

## CERTIFICATE OF SERVICE

I, Vivian I. Lee, do hereby certify that copies of the foregoing MCI Worldcom Reply Comments were sent via first class mail, postage paid, to the following on this 17th day of September, 1998.

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\*HAND DELIVERED

  
Vivian I. Lee

# **Furman Selz (Frederick W. Moran (212) 309-8990) AT AT.SG - "Bundled" Strategy in Secondary MSA/Rural Markets;**

Aug 26 1998 10:02

## **WIRELESS TELECOMMUNICATIONS**

ALLTEL Corporation  
(NYSE: 44 5/16-AT)

"Bundled" Strategy in Secondary MSA/Rural Markets;  
Initiating Coverage with a Strong Buy Rating and \$58 Target

August 26, 1998

Frederick W. Moran (212) 309-8990  
Peter C. Friedland (212) 309-8509

## **STRONG BUY**

52-Week Range:	\$49-31	EARNINGS PER SHARE				
Daily Volume(000s):	550		1997	1998E	1999E	2000E
Shares O/S(mil):	274	Mar	\$0.36	\$0.46	\$0.55	NA
Market Cap(mil):	\$12,142	Jun	\$0.43	\$0.52	\$0.66	NA
EBITDA Growth:	13%	Sep	\$0.46	\$0.54	\$0.67	NA
Debt/Capital:	53%	Dec	\$0.48	\$0.55	\$0.67	NA
Book Value/Share:	\$11.35	Year	\$1.73	\$2.08	\$2.55	\$3.05
Dividend/Yield:	\$1.16/2.6%	P/E	25.6 x	21.3 x	17.4 x	14.5 x
Insider Holdings:	3%	EBITDA	\$1,701	\$1,914	\$2,170	\$2,410
S & P 500:	1092.86	Mult.	9.2 x	8.2 x	7.2 x	6.5 x

Note: Numbers may not add because of rounding.

\* We are initiating coverage of ALLTEL with a Strong Buy rating and a 1999 price target of \$58.

\* ALLTEL has 3.7 million cellular, 1.8 million **local telephone**, 427,000 long distance, 150,000 paging and 40,000 Internet customers located primarily in the Southeast and Great Lakes/Mid-Atlantic region, as well as 1,100 information services customers located in 48 countries worldwide.

\* We believe AT shares are an attractive way to take advantage of: 1) ALLTEL's smaller metropolitan and **rural** markets, which are likely to experience less competition than more urban markets, and; 2) ALLTEL's complete suite, or "bundle" of services, which not only maximizes the revenue and profit potential per customer, but creates high customer loyalty.

\* Following the \$6 billion acquisition of 360° Communications in July 1998, ALLTEL is poised to benefit from both operating synergies and additional revenue opportunities as the company markets its bundle of services to 360° customers. Moreover, we believe ALLTEL has transitioned into more of a pureplay telecom carrier, with the vast majority of its revenue coming from its telecom business, which should enable the company to receive full value for its total bundle of telecom services.

\* We expect ALLTEL to post more than 15% compound annual EPS growth over the next five years, driven by: 1) synergies and revenue enhancement opportunities resulting from the integration of 360°; 2) the sell-through of the company's complete suite of services to customers, and; 3) the transport of a greater



percentage of traffic on the company's own network, thereby reducing costs.

#### Investment Viewpoint

We believe AT shares have not received full valuation recognition because prior to the 360° acquisition, ALLTEL was primarily viewed as: 1) a steady growing **rural local** exchange company with; 2) an information services segment, accounting for 30% of the company's revenue—this description not only made ALLTEL less “sexy” than other plays on the telecommunications business, but the company's information services business made the stock difficult to value, and consequently resulted in minimal research coverage from Wall Street, despite its listing on the S&P 500 and multi-billion dollar market capitalization.

However, given the recently completed acquisition of 360°, we believe ALLTEL should receive an enhanced valuation for its now more pure telecommunications make-up, with more than 80% of its EBITDA coming from telecommunications services. ALLTEL's primary businesses include:

- expansive cellular footprint, covering 33 million POPs and 3.7 million subscribers with nearly contiguous coverage of the Southeast;

- insulated **rural local telephone** exchanges, with 1.8 million access lines;

- growing long distance and CLEC businesses, and;

- extensive 8,500-mile long-haul fiber network, connecting virtually all of the company's **local telephone** and wireless operations—the network should be fully in place by the first quarter of 1999.

Together, these businesses should allow ALLTEL to address its customers with a complete suite of telecommunications services, while at the same time, ALLTEL's expansive wireless and wireline network should enable the company to maximize profitability by transporting the majority of the company's traffic over its own network. In addition, ALLTEL's information services business, which provides the company with a consistent source of double-digit revenue and EBITDA growth, can be leveraged by the company to streamline the operations of its telecommunications businesses, further enhancing profitability.

#### Valuation

We believe AT shares trade at a significant discount to its peer group (composed of the RBOCS and other hybrid **local** telephone/cellular companies) on a P/E-to-growth ratio and EBITDA multiple-to-growth ratio basis. AT shares currently trade at a 1999 P/E-to-growth ratio of 1.2x versus the peer group at 1.9x, and a 1999 EBITDA multiple-to-growth ratio of 0.5x versus the peer group at 0.8x.

We believe this suggests that AT shares should command premium P/E and EBITDA multiples relative to the peer group to compensate for the company's above average growth—we expect ALLTEL to achieve more than 15% compound annual EPS growth over the next five years versus 10% for the peer group, and 13% 1999 EBITDA growth versus 9% for the peer group. If ALLTEL were to trade at P/E and EBITDA multiples more in line with its expected growth rates, AT shares would trade into the \$70 range.

Based on a 15% discount to our 1999 sum-of-parts private market value of \$68, we arrive at a 1999 price target of \$58—this represents a 23x multiple of our 1999 EPS estimate of \$2.55, and 9x our 1999 EBITDA estimate of \$2.2 billion.

Additional information available upon request. Stock priced as of previous session's close.

First Call Corporation - all rights reserved. 617/345-2500



# **PaineWebber (Walter Piecyk/William Choi (212)71) CTL - CENTURY TELEPHONE: NOTES FROM INVESTOR FC MEETING**

Sep 16 1998 07:50

PW PW PW PW PW PaineWebber PW PW PW PW PW

Rating=1 (CTL)  
Closing Price=\$49 7/16  
Current FY EPS EST=\$2.02  
Next FY EPS EST=\$2.40  
FY End=December

9/16/98

FY End: Dec	1997A	1998E	1999E
Q1 EPS	\$0.37	\$0.45 (A)	\$0.54
Q2 EPS	\$0.41	\$0.53 (A)	\$0.59
Q3 EPS	\$0.45	\$0.56	\$0.68
Q4 EPS	\$0.41	\$0.48	\$0.60
FY EPS	\$1.64	\$2.02	\$2.40
P/E	30x	25x	21x

Shares:	94 Million	52-wk high/low	\$52 11/16 - 23 15/16
Market cap	\$4.7 Billion	Target	\$60
Net Debt	\$2.5 Billion	Avg daily vol	227,000 shares
TEV	\$7.2 Billion		

**COMPANY DESCRIPTION** - CenturyTel is a **local telephone** and cellular provider that operates in **rural** markets throughout the Southeast, Midwest and Alaska. It operates in excess of 10 million cellular POPs, 1.2 million access lines and provides long distance service to 204,000 subscribers.

**INVESTMENT THESIS** - We prefer an investment in CenturyTel (CTL) because it provides an attractively valued opportunity to play in a multi-faceted telecommunications service company. Its **rural** operations offer higher growth and less competition than seen in major markets.

**KEY DRIVERS** - We believe that CenturyTel trades on reported EPS. Further improvements in the company's cellular operations could have a positive impact on the stock.

**RISKS** CenturyTel is in an increasingly competitive industry which contains risk of further competition, regulatory risk and potential pricing pressures.

## KEY POINTS

1. Yesterday (9/15), CenturyTel held an investor meeting in New York in which it focused on its low risk **rural** characteristics, growth, bundling plans and customer service focus.
2. Further revenue and cost leverage is available from recent PTI acquisition.
3. New customer retention initiatives and pre-paid plan could lower the churn and raise the cash flow margins further. CenturyTel's cellular business.
4. Innovative PCS service offering targets **local** loop replacement via wireless.

5. Reductions in cap-ex in 1999 will further leverage strong cash flow growth.
6. Maintain Buy rating, with 12-18 month price target of \$60.

## YESTERDAY, CENTURYTEL HELD AN INVESTOR MEETING IN NEW YORK IN WHICH IT FOCUSED ON ITS LOW RISK **RURAL** CHARACTERISTICS, GROWTH, BUNDLING PLANS AND CUSTOMER SERVICE FOCUS.

CenturyTel repeatedly emphasized the non-competitive benefits of its **rural** markets and its intent to leverage its multitude of services with its existing customers. CenturyTel has noticed an acceleration in population growth recently, which it believes will benefit its business, most importantly from an increase in the available number of business customers. Currently 26% of CenturyTel's access lines are business customers, which will likely grow as a result of the growth in these regions. CenturyTel's bundle offers a broad array of services including paging, cellular, long distance, **local** service, home security, telemetry, and Internet. It provided data from recent independent surveys which indicated that 55% of customers prefer to purchase service from a single carrier and 69% would like information on a single bill.

## FURTHER REVENUE AND COST LEVERAGE AVAILABLE FROM RECENT PTI ACQUISITION.

The acquisition of PTI continues to help the overall results of the company as those markets had been under-utilized by their prior owners. We believe CenturyTel's modest increase in marketing in the former PTI markets could generate a sequential increase in the revenue per access line in the third quarter. We currently estimate a slight sequential decrease in the third quarter. The billing conversion is complete and 90% of the accounting systems have been transferred. It has already signed up 10,000 long distance customers in the former PTI markets. Telco cash flow margins are already a strong 54

## NEW CUSTOMER RETENTION INITIATIVES AND PRE-PAID PLAN COULD LOWER THE CHURN AND RAISE THE CASH FLOW MARGINS FURTHER IN CENTURYTEL'S CELLULAR BUSINESS.

Churn in CenturyTel's wireless markets has long been a concern of ours because of the importance on return on invested capital. When CenturyTel hired Margaret Osbourne to handle wireless marketing and customer retention last year, we were encouraged because of the low churn she achieved at her previous company, Palmer Wireless. Although the rate of change in the churn rate has not yet been dramatic, the direction is positive. We believe that several of the new customer retention programs, which are just 60 days old, could have an impact in future quarters (Q4,Q1). In addition, the point of sale alternative of a pre-paid product, which requires no credit check and includes no subsidy, could lower CenturyTel's overall customer acquisition costs.

A Pre-Paid customer pays \$100 for a phone and 30 minutes of service. The minutes are deducted by 1 minute per day if they are not used and the customer is disconnected if there is no recharge within 60 days. We have not seen a substantial difference in the ARPU (average revenue per unit) between pre-paid and credit based customers probably because of the cash rich credit challenged customers which are early adopters. The cost of the phone being offered, a cheap analog model, is roughly \$70, the commission is \$10. These leaves roughly \$20 to cover advertising, overhead and the network expense if the minutes are actually used. The current pricing thereby implies a customer acquisition cost of \$0. If Pre-paid customers represent 20%-30% of net

adds, it will likely have a noticeable impact on customer acquisition costs.

## INNOVATIVE PCS SERVICE OFFERING TARGETS **LOCAL** LOOP REPLACEMENT VIA WIRELESS.

Details were still scarce on CenturyTel's new PCS offering in Grand Rapids Michigan. This offering is relatively innovative as it is targeting **local** loop replacement over wireless networks. For a flat rate customers are provided unlimited service on the small PCS network. Dual mode phones will then enable those customers to roam onto the larger service areas of the cellular networks. CenturyTel has worked closely with Nortel, its primary vendor in developing a low cost provision of service. We believe wireless networks of the future will be designed in this manner.

## REDUCTIONS IN CAP-EX IN 1999 WILL FURTHER LEVERAGE STRONG CASH FLOW GROWTH.

5%-10% cuts in capital spending in telco services was new information to us and provides a positive surprise to our current estimate. CenturyTel believes it is well prepared for the proliferation of broadband services as 86% of interoffice trunking is over fiber. Last mile solutions continue to be examined and included Nortel's one-Meg modem, DSL solutions etc. Cap-ex for its wireless networks overall will not decline as the company will continue to invest in PCS networks. On the cellular side, digital conversion is winding down as 80% of CenturyTel's MSA POP's are digital and that is likely to rise to 90% by year end.

Of the \$650 million of cash flow we expect from operations next year, CenturyTel will use \$225 million for its purchase of the Ameritech business lines. Cap-ex spending will eat another \$325 million resulting in roughly \$100 million to continue to pay down debt. As debt to total market capitalization ratios approach 50%, CenturyTel will reassess the opportunity to repurchase stock.

## MAINTAIN BUY RATING, WITH 12-18 MONTH PRICE TARGET OF \$60.

Our 12 month price target of \$60 is based on 25 times our 1999 EPS estimate of \$2.40, implying a 22% return potential from current prices. CTL currently trades at 25x our 1998 EPS estimate of \$2.02. Although other stocks we rate with a Buy offer greater return potential, it is important to note the relative lower risk and free cash flow generation of CenturyTel.

### Companies mentioned:

Century **Telephone** CTL (3),

SBC Communications SBC (3)

3PaineWebber Inc. has acted in an investment banking capacity for this company.

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July 9, 1998  
New York

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**JPMorgan**

## Company Report

# Century Telephone Enterprises

## Rural Telecom Titan

Initiating  
Coverage:

**BUY**

**CenturyTel is the premier consolidator of rural telephone properties**, with numerous advantages over the major incumbent local exchange carriers (ILECs). It is the 10<sup>th</sup> largest local wireline and wireless operator in the country but benefits from some advantages not shared by its larger peers. In particular, its rural and suburban geography offers attractive growth prospects while at the same time deterring potential competitors. CenturyTel also benefits from a more favorable regulatory climate than the RBOCs. It already offers long-distance service and is not required to comply with some of the more onerous elements of the 1996 Telecom Act. Its superior growth prospects are enhanced by its wireless business, which contributes 26% of revenues, nearly twice as much as for the Bells.

**We have been impressed by CenturyTel's ability to create value.** The company's prominence has increased in the past couple of years as it has strengthened its position as the premier consolidator of rural telephone properties. It almost doubled in size with its 1997 purchase of Pacific Telecom from PacifiCorp and more recently reached an agreement to purchase more than 85,000 access lines to add to its properties in Wisconsin. Through promotion of new products and services, as well as expense synergies, CenturyTel creates significant value from such transactions.

**We believe that CenturyTel can produce average annual EPS earnings growth of 16%** from 1997 to 2002, well ahead of the 11% average expected from the RBOCs. We consider the quality of our CenturyTel earnings projections to be higher than the RBOCs', thanks to the dramatically lower competitive risk. About half of the company's earnings growth will come from the top line, with productivity improvements and deleveraging as a result of strong free cash flows contributing as well.

**We rate CTL a Buy with a 12- to 18-month target price of \$54.** We believe Century is attractive, even after having risen 44% so far in 1998 on top of a 61% gain in 1997. CTL currently trades at 21 times our 1999 earnings projection, a 7% discount to the market (S&P 500), and a 25% premium to the major ILEC average. We believe Century's premium to the major ILECs is justifiable and sustainable because of its superior earnings outlook, and we see 14% total return potential. We believe that by the end of 1999, CTL has the potential to trade at about 21 times our 2000 EPS estimate of \$2.62.

### Common Stock (NYSE: CTL)

			EPS	P/E		
Price (7/8/98)*	\$48.88	1997	\$1.64	29.8	S&P 500	1,166.37
52-Week Range	\$50-23	1998E	\$1.92	25.5	Market Cap.	\$4,448MM
Dividend	\$0.26	1999E	\$2.29	21.3	Shares Out.	91.0MM
Yield	0.5%	2000E	\$2.62	18.7	Institutional Ownership	73.5%
Book Value per Share	\$14.90	2001E	\$3.02	16.2	Avg. Daily Volume	282,202

\* Data in this table as of 7/8/98's close; all other data and valuation reflect 7/6/98's close of \$47.81.

The Telecommunications Equity Research group recently published the following reports:

*Qwest Communications* (6/26)

*ILECs* (5/27)

*RBC Communications* (5/20)

Telecommunications Equity Research:

Simon Flannery

(1-212) 648-8317

Margaret Berghausen

(1-212) 648-9416

Marina Yu

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## INVESTMENT THESIS

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### Positives

#### **Leading Rural Telephone Company**

Century Telephone is the 10<sup>th</sup> largest wireline and wireless operator in the United States and the largest rural telephone company in the nation, with properties clustered in the Midwest, Northwest, and South. We believe that its rural profile offers a number of attractions for investors. First, rural America has been enjoying a resurgence in population growth, which should allow Century to produce annual access line growth of about 5%, ahead of the 4.2% average for the Baby Bells. Second, Century's rural markets are less attractive to potential competitors (wireline and wireless) than the major metro markets, a position that is reinforced by special protection under the Telecom Act of 1996.

#### **Adding Value as an Industry Consolidator**

Century has grown in prominence in the past 12 months following a series of significant acquisitions that have more than doubled its access lines, to 1.2 million. In December, Century completed the \$2.2 billion purchase of Pacific Telecom, and just this March, it announced the purchase of more than 85,000 lines in Wisconsin from Ameritech. We believe that Century is in a great position to add value to the properties it acquires by reducing costs as a result of scale economies and by driving incremental revenue growth through introduction of new products and services. We also see significant potential for additional consolidation in the rural telecom sector.

#### **Strong Cash Flows Provide Considerable Financial Flexibility**

Century generates very strong free cash flow, which provides the company with significant financial flexibility to pursue additional acquisitions and pay down debt. Indeed, Century's ability to deleverage will be a significant contributor to earnings growth. Prior to its acquisition of PTI, Century maintained a fairly low debt to cap ratio of about 40%; following the acquisition, the ratio stood at 67%; we expect it to drop to about 46% in the next five years. We estimate that Century will generate free cash flow (net income + depreciation - capex - dividends) of \$133 million in 1998, even with dilution from the PCS, long-distance, and call center operations. Cash flow should grow to \$352 million by 2002, in our estimation.

#### **Above-Average Growth Prospects**

Given the strengths outlined above, we are confident that Century can deliver earnings growth well in excess of the 11% average projected for the major operators. We expect 16% compound earnings growth for 1997-2002, consistent with the company's strong track record: For the past five years, Century produced compound annual EPS growth of 16%, considerably above the sector average of under 10%.

#### **Attractively Valued**

Our 12- to 18-month target price for CTL is \$54. We believe Century offers attractive value to investors, even after having risen 44% so far in 1998 on top of a 61% gain in 1997. CTL currently trades at 21 times our 1999 earnings projection, a 7% discount to the market (S&P 500), and a 25% premium to the major ILEC average. We believe Century's premium to the major ILECs is justifiable and sustainable because of its superior earnings outlook, and we see 14% total return potential. We believe that by the end of 1999, CTL will trade at about 21 times our 2000 EPS estimate of \$2.62.



## Less Competition

**The big cloud over most major local telephone stocks is competition.** The Telecom Act of 1996 opens up the local loop to competition and sets out onerous pro-competitive measures that major telcos must take to comply with the law and to satisfy requirements for long-distance entry. Many investors worry that the major local carriers will face significant share loss and pricing pressure from aggressive new entrants skimming off their best customers. If competitive risks were eliminated, we would not be surprised to see the major telcos trading at market multiples or better, representing at least 25% upside from current levels.

*See page 17, Century's  
Regulatory Environment Is  
Very Attractive, for details*

**The competitive situation for Century is dramatically different from that of the major ILECs, and it is much more attractive for investors.**

- **Century is exempt from many onerous requirements of the Telecom Act**, by virtue of being a small telephone company (less than 2% of the nation's access lines).
- **Century is already permitted to offer long-distance services** and therefore does not need to go through the painful S. 271 application process.
- **Century's rural territory makes competing against it very unattractive** because of low population density and high construction costs. This applies to both wireline and wireless rivals. For example, Century's largest market is Lorraine, Ohio, and it has only about 75,000 lines. Its lines per exchange average fewer than 5,000.

**To date, Century has not signed a single interconnection agreement**, has had only a few requests for resale, and has not lost any lines. This is in stark contrast to the situation at Bell Atlantic, for example. In Pennsylvania alone, nearly 90 companies have filed to compete for local service, and Bell Atlantic has already lost some 55,000 lines to its rivals. We assume that Century will lose 6-7% market share in the next five years, with about 85-90% of those lines lost to resale competitors. We believe the RBOCs could lose closer to 20%, with a greater percentage lost to complete bypass or unbundled loops.

## Rural Consolidator

**One of the most interesting elements of the Century story is its role as a consolidator** of rural telephone companies. Nationally, the local telephone industry is dominated by the Baby Bells, which operate about 80% of the nation's access lines. The remaining 20% is very fragmented and is spread among more than 1,000 small independent operators. We concur with Century's view that there are significant opportunities for value creation through acquisition and integration of other local telephone properties.

**There are several ways one can extract value from such acquisitions.** Cost savings from economies of scale should be fairly obvious, with opportunities to cut procurement costs and eliminate duplicate operations, such as finance functions as well as shared systems platforms. In some cases, the introduction of more modern management techniques can yield significant benefits. Revenue synergies should not be ignored either, since many smaller companies are less aggressive in pushing value-added services, second lines, and long-distance service.

**Century estimates that the PTI acquisition will add \$20 million in pretax synergies** (cost and revenue) over three years. PTI's properties have lower vertical service penetration and have not offered long-distance service at all, representing significant revenue opportunities. In the case of lines purchased from Baby Bells such as Ameritech, Century will be able to offer customers long-distance service, whereas Ameritech was barred from doing so.